

SUBJECT: Sale of local water bonds held by water board

COMMITTEE: Natural Resources: favorable, without amendment

VOTE: 5 ayes--J. Harris, C. Johnson, Holzheuser, Shelley, Yost  
0 nays  
1 present, not voting--T. Smith  
3 absent--Hammond, Russell, Toomey

WITNESSES: For--Steve Stagner, Texas Water Alliance  
Against--Arthur Postel  
On--Reg Arnold, Texas Water Development Board

BACKGROUND: The Texas Water Development Board helps cities and water districts finance water development projects through low-interest loan programs. The board sells general-obligation bonds backed by the state and uses the proceeds to purchase bonds and securities issued by a political subdivision constructing a water project. The board's portfolio of municipal bonds generates income from the debt service paid by the political subdivisions. The board uses this income to service its own bond debt.

Ideally the board's debt is structured so that its bond income matches its bond payments. If, however, the board's income fell short, it would be forced to draw on general revenue to pay its bond obligations. A cash-flow imbalance that could lead to a draw on general revenue could result either from a default on a municipal bond or from investing in long-term projects, such as reservoir storage acquisition projects, that have a long lead time until they generate income.

The board can sell its municipal bonds for their cash value in the bond market. However, the board must give the issuing political subdivision the opportunity to buy back its bonds before they are sold on the market. If the political subdivision does not buy back the

bonds, then the board must give notice of the sale and take competitive bids on the bonds.

HB 1127 by Craddick, reported from the Natural Resources Committee on April 1 and currently pending in the Calendars Committee, would create the Texas Water Resources Finance Authority, which could purchase municipal bonds from the water development board.

DIGEST:

HB 734 would authorize the Texas Water Development Board to sell municipal bonds acquired with money from the Water Loan Assistance Fund, the Water Development Fund or the Agricultural Water Conservation Fund to the Texas Water Resources Finance Authority.

Proceeds from the sale of water-loan bonds would be deposited in the loan assistance fund. Proceeds from the sale of bonds from the development fund or the agricultural water conservation fund could be used to redeem outstanding water development bonds, water-quality enhancement bonds, and agricultural-conservation bonds. The board could invest the funds. The interest on money from the sale of bonds originally acquired with money from the development fund or the agricultural water conservation fund would be deposited in the development fund, the administrative fund or the agricultural water conservation fund.

The board would determine the price and the terms for selling its municipal bonds. The board could sell its bonds to the authority without first giving the issuing political subdivision an opportunity to buy the bonds, without giving notice of the sale and without taking competitive bids.

The board could contract with the authority to sell it municipal bonds not yet acquired by the board. In such a transaction, the authority could pay the board before receiving the bonds. When the board acquired the bonds, it would transfer them with interest to the authority.

The authority could contract with the board to administer the debt service on the authority's municipal bonds.

SUPPORTERS  
SAY:

HB 734, in conjunction with HB 1127 by Craddick, would allow the Texas Water Development Board to restructure its debt by shifting future income into the present, and thereby avoid potential draws on general revenue.

Although there is no imminent danger of a draw on general revenue, the board's municipal-bond income over the next 10 years will only be equal to, or slightly more than, the debt payments it owes. After the late 1990s, however, the board's bond income will significantly exceed its debts. HB 734 would even out this cash-flow imbalance by allowing the board to sell part of its municipal bond portfolio to a new Texas Water Resources Finance Authority. The board would place the proceeds from the sale of its municipal bonds in an investment fund, which would provide an additional buffer against a general-revenue draw as well as pay the board's future debt obligations. This transaction would, in effect, move some of the excess funds from the back end of the bond maturity schedule to the front end where they are needed.

The board could also use its bond-sale proceeds from the authority to pay off, or to "defease," part of the outstanding debt that it has accumulated over the years. However, the board would not be able to defease all its outstanding debt, as was projected when similar legislation was proposed in 1985. The federal Tax Reform Act of 1986 now bars the board from keeping the arbitrage profits that would previously have provided the money with which to defease the debt. (Arbitrage profits generally are the profits earned from investing bond proceeds before they are actually spent.)

The Texas Water Resources Finance Authority would not be a new administrative agency. It would merely be a financing vehicle through which the water development board could cash in its bonds. The authority would be the alter ego of the board, which would control and operate the authority.

Creation of the authority would give the board the benefits from selling its municipal bonds while preserving the advantage of having the state own the bonds. Although the board now can sell its municipal bonds in the bond market, such a sale to a third party necessarily means that the state and the issuing political subdivision lose control over the bonds. It helps political subdivisions to have the state, rather

than a third party, own the bond, in case the political subdivision has difficulty completing the project and performing on the bond. In this situation the state is typically more flexible than an outsider in allowing the political subdivision latitude to work out the problem. The law now protects political subdivisions from such potential problems by letting them buy back their bonds before they are sold on the open market. They would not need such protection if the board sold their bonds to the authority, because the bonds would remain under the state's control.

It also would be unnecessary for the board to notify political subdivisions of sales or to notify the public and take competitive bids, as currently required. In effect, the board would be selling the bonds to itself and not to the public at large. Indeed, such restrictions would prevent these transactions because the board would be unable to move fast enough to take advantage of favorable market transactions. The board's ability to be able to sell its municipal bonds to the authority when interest rates are low would be essential to making the transaction work.

The authority would finance the purchase of municipal bonds by selling revenue bonds. Unlike general obligation bonds that are backed by the state, revenue bonds are secured by the income generated by a project, or, in this case, from the income generated by repayment of bond debt. The authority would buy the board's municipal bonds with the proceeds from the sale of revenue bonds, then pay debt service on the revenue bonds with the income from the municipal bonds. The authority could issue as many revenue bonds as the income stream from its municipal-bond portfolio would support. This would depend entirely on the market conditions at the time of the transaction. The higher the interest rates, the fewer bonds it could sell; the lower the interest rates, the more bonds it could sell.

OPPONENTS  
SAY:

HB 734, in conjunction with HB 1127 by Craddick, would provide an open-ended grant of authority to fund water projects without public approval. The authority would have no limit on its bonded indebtedness, because it would buy municipal bonds with the proceeds from the sale of revenue bonds, which unlike general obligation bonds do not require voter approval. Since revenue bonds are secured by the income generated by a project, the authority could issue as many revenue bonds to

finance water projects as the income stream from the municipal bonds would support.

Over-investment in water development projects can lead to many undesirable results. Water projects endanger the state's bays and estuaries by reducing fresh-water inflows from the rivers to the Gulf of Mexico. Water projects also contribute to the erosion of state's coastline by preventing silt and sediment that would otherwise be deposited along the shore from reaching the coast. Finally, water projects are expensive and waste valuable resources that could be put to more productive uses.

The authority could cause a draw on general revenue, if its debt payments on its revenue bonds exceeded the income from its municipal bonds. Although the authority could only issue revenue bonds, and the state expressly denies responsibility for backing such bonds with its full faith and credit, the state could not escape the financial responsibility for paying the debt service on the bonds in the event of a default on the authority's municipal bonds. The state would ultimately have to back the authority's revenue bonds in order to avoid the consequences that a default on the revenue bonds could have on the state's bond rating.

OTHER  
OPPONENTS  
SAY:

Why is the House considering the a bill that would give substantial authority to a Texas Water Resources Finance Authority when that agency does not yet exist? Acting on HB 734 before considering the bill that would actually create the authority seems to be putting the cart before the horse.

NOTES:

The companion bill to HB 724, SB 470 by Jones, was referred to the Senate Finance Committee on Feb. 24.

In 1985 a similar bill, HB 2465 by Craddick, passed the House on the Local and Consent Calendar and was reported from the Senate Finance Committee. On May 26 the motion to suspend the regular order of business so the Senate could consider the bill lost by 17 yeas to 13 nays, failing to receive the necessary two-thirds vote.